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COMMONWEALTH OF KENTUCKY
SUPREME COURT OF KENTUCKY
CASE NO. 2013-SC-000497

NOBE BAKER INDIVIDUALLY AND AS ADMINISTRATOR OF THE ESTATE OF JOANN BAKER, et al. — APPELLANTS

v.

APPEAL FROM COMMONWEALTH OF KENTUCKY

COURT OF APPEALS CASE NO. 2012-CA-1016

MAGNUM HUNTER PRODUCTION COMPANY, INC. — APPELLEE

BRIEF OF AMICUS CURIAE
KENTUCKY OIL AND GAS ASSOCIATION, INC.

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CERTIFICATE OF SERVICE

I hereby certify that a true and accurate copy of the Brief of Amicus Curiae Kentucky Oil and Gas Association, Inc. was served by United States First Class Mail, postage prepaid, on this the 27th day of August, 2014, upon Hon. James L. Bowling, Special Judge of Harlan Circuit Court, Harlan County Justice Center, 129 S. First St., Harlan, KY 40831; George E. Stigger, 236 Cardinal Circle West, St. Marys, GA 31558; John C. Whitfield, Whitfield Bryson & Mason, LLP, 19 North Main Street, Madisonville, KY 42431; Anne A. Chesnut, R. Clay Larkin, Bingham Greenebaum Doll, LLP, 300 West Vine St., Suite 1100, Lexington, KY 40507; and Harry D. Callicotte, Senior Corporate Counsel – Land, Magnum Hunter Production Company, Inc., 120 Prosperous Place, Lexington, KY 40509. I further certify that the record on appeal was not removed by this amicus curiae.

G. Brian Wells

STATEMENT OF POINTS AND AUTHORITIES

May It Please The Court:

INTRODUCTION

For many decades oil and gas leases have provided that the landowner would receive royalties on natural gas based on the "market price" or "market value" "at the well" or other similar language. Parties to such oil and gas leases have generally understood that if there is no active market for the product at the well, the "market price at the well" for royalty purposes will have to be calculated. That calculation "works back" from the actual sales price of the gas and deducts the costs of gathering and treating the gas and compressing and transporting it to the sales point.

This understanding of "market value at the well" is so universal that *Black's Law Dictionary*, 9th Edition (2009) actually defines "market value at the well" as "the value of oil and gas at the place where it is sold, minus the reasonable cost of transporting it and processing it to make it marketable."

Since at least the 1920's, Kentucky law has been in accord with this common understanding of "market price at the well." If the value of oil and gas is required to be established by lease or otherwise "at the well," Kentucky courts have held that such a determination must be made, even if no sale actually occurs at the well. In so holding, Kentucky law follows the majority "at the well" rule, which permits the producer to deduct post-production costs such as gathering, compression, treatment and transportation of the product to arrive at a value "at the well."

The Appellants are now asking this Court to ignore this longstanding Kentucky precedent and instead to adopt a minority rule, "marketable product" concept that has no support under Kentucky law.

The "marketable product rule" espoused by the Appellants is not based on the terms of their lease contract. Rather it derives solely from an unreasonably expansive interpretation of a judicially-implied lease covenant. Generally, that rule turns a judicially-implied covenant that lessee will market the gas to a requirement that the lessee pay all the post-production costs of getting the gas to a distant market, while giving the lessor the benefit of the higher market price. *See, Poplar Creek Development Co. v. Chesapeake Appalachia, LLC*, 636 F.3d 235, 240 (6th Cir. 2011).

Conversely, the "at the well" rule provides "that while there is an implied duty or covenant to market the gas, this duty does not extend to expenses incurred in sales not at the well-head; post-production costs are to be shared proportionately by the working interest and royalty owners." *Id.* at 240-41 (citing *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887, 894 (Mich. App. 1997). This rule allows the product to be valued "at the well" by deducting expenses from the sales price generated at a distant market. In arguing for the adoption of the marketable product rule, the Appellants seek to disturb well-settled Kentucky caselaw which follows the "at the well" rule and gives meaning to lease terms requiring payment of a royalty based on "market price at the well."

The Kentucky Oil and Gas Association ("KOGA") appears as *amicus curiae* out of concern that the Court of Appeals not abandon this longstanding Kentucky law. The continued application of these principles is critical to KOGA, a 501(c)(6) non-profit industry association established in 1931 to advance the oil and natural gas business in Kentucky, and to its members. KOGA represents the interests of 220 member companies and over 600 member representatives engaged in oil and gas production, drilling, operations, and related enterprises in Kentucky. A reversal of that practice, as requested by Appellants, would have a devastating effect on many of the small producers who are the backbone of Kentucky's $1.1 billion oil and gas industry.[1]

Common sense and fairness dictate that when the parties say they will value gas for royalty purposes "at the well," a value will be established "at the well." The only way that value can be computed is by deducting the costs of selling the gas at a distant market (such as the costs for gathering, compression, and treatment) from the higher market price, to determine an "at the well" value. Allowing lessors, like the Appellants here, to reap the benefit of a higher market price, without paying their proportionate share of the costs necessary to achieve that price, would grant them a unfair windfall disfavored by Kentucky law.

Any change in existing law would discourage development of Kentucky's oil and gas resources, contrary to the state's public policy to "encourage exploration for [all minerals] . . . and to encourage the maximum recovery of oil and gas from all deposits thereof . . . ." KRS 353.500(1). KOGA urges the Court to maintain the current state of the law and to affirm the decision of the Court of Appeals below.

ARGUMENT

I. THE COURT SHOULD RETAIN THE "AT THE WELL" RULE ALLOWING DEDUCTION OF GATHERING, COMPRESSION, AND TREATMENT COSTS IN DETERMINING THE VALUE OF GAS "AT THE WELL."

Kentucky courts have long found it appropriate to deduct post-production costs such as gathering, compression, and treatment to arrive at the "market price at the well" of oil or gas. *Cumberland Pipe Line Co. v. Commonwealth*, 15 S.W.2d 280 (Ky. 1929);

[1]Available at: http://koga2.msiconnect.com/Portals/205/PDFs/KOGA_EconomicImpactResearch_2013.pdf.

Rains v. Kentucky Oil Co., 255 S.W. 121 (Ky. 1923); *Warfield Natural Gas Co. v. Allen*, 88 S.W.2d 989 (Ky. 1935); and *Reed v. Hackworth*, 287 S.W.2d 912 (Ky. 1956). This rule is logical, and it implements the parties' agreement. It should continue to govern the calculation of royalties in cases such as this.

A. Kentucky Law Supports The Deduction Of Post-Production Costs To Derive A Value "At The Well."

In *Cumberland Pipe Line*, Kentucky's highest Court approved the deduction of post-production costs in determining the market value of oil "at the well," even though the oil was actually sold at a distant location. In that case, a pipeline company challenged the constitutionality of a tax levied on the "market value" of all crude petroleum produced in Kentucky. *Cumberland Pipe Line* at 281. The oil in question was produced in Kentucky, but it was transported and sold out of the state. The pipeline company challenged Kentucky's authority to impose the tax because there was no market value for the oil at the well. It asserted that since the oil was sold and valued out of state, the tax violated the Interstate Commerce Clause.

The Court disagreed finding that because no market existed at the place of production, the oil had to be transported to be sold. It further found that even though the sale was not at the wellhead, a wellhead price could (and should) be calculated. It approved the deduction of post-production costs from the sales price at the distant market to arrive at a wellhead price, saying:

> There is seldom, if ever, a market at the place of production. The product must be carried to the markets. The value at the place of production is the selling price less the cost of transportation to the place of sale.

Id. at 284.

The Court reasoned that the deduction of the costs of transportation to the place of sale is necessary to calculate the "market value" of a product like oil or gas at the wellhead. The Court explained that this "method is not a new one, but conforms to the legal rules of evidence for the ascertainment of market value." *Id., citing* 22 C.J.S. § 151, *inter alia*. The Court also relied on earlier Kentucky cases concerning coal and timber that applied the same rule:

> The market value of a commodity is its selling price in the usual and ordinary course of business, but, if there be no market at a particular place at which it is desired to fix the market value, then the market value is taken at the nearest point available, **with adjustments to care for the cost of transportation to that market.** (Emphasis added).

Id., citing Campbellsville Lumber Co. v. Bradlee & Wiggins, 29 S. W. 313 (Ky. 1895); *Log Mountain Coal Co. v. White Oak C. Co.*, 174 S. W. 721 (Ky. 1915).

Thus, as early as 1929, Kentucky's courts held that the "market value" of oil and gas at a particular location must be ascertained by looking to the price at which it was ultimately sold "with adjustments to care for the cost of transportation to that market."

Recognizing that *Cumberland Pipeline* defeats their position, the Appellants attempt to limit its application to the deduction of transportation costs. That argument is unavailing because the principle of *Cumberland Pipe Line* applies with equal force to gathering, compression, and treatment costs. All of those activities (and their attendant costs) are necessary to sell the gas at a distant market and enhance its value.

In *Poplar Creek*, the Sixth Circuit Court of Appeals directly addressed that argument and soundly rejected it, stating:

> We fail to see . . . how gathering, compression and treatment expenses are materially distinguishable from 'transportation' costs. At least two of these expenses, gathering and compression, are clearly necessary to transport gas. The third cost, treatment, increases the value of that gas at its final destination. *Cumberland Pipe Line* therefore strongly suggests that Kentucky courts would deduct such costs from the market price in order to determine the gas's value at production.

Id. The reasoning in *Poplar Creek* is sound, and this Court should similarly reject the Appellants' attempt to limit the holding of *Cumberland Pipe Line* to transportation expenses.

Gathering and compression are essential components of gas transportation. Without gathering and compression, the gas would never get to the market, and it would never be sold at an increased price that takes the value of that transportation into account. Kentucky's oil and gas regulations at 805 KAR 1:190 expressly recognize that "gathering" is an integral part of transportation. That regulation defines "gathering line" as "any pipeline that is installed or used for that purpose of ***transporting*** crude oil or natural gas from a well or production facility to the point of interconnection with another gathering line, an existing storage facility or a transmission or main line . . . ." (emphasis added). Compression is an essential element of transportation as it is necessary to move the gas through gathering lines and into higher-pressure gas transmission lines.

Gathering, compression and transportation costs, like the costs of treatment, increase the value of the gas, and they must be deducted from a distant sales price to calculate the value of the gas "at the well."

B. Kentucky Law Supports Valuing Gas At The Wellhead.

In *Rains v. Kentucky Oil Co.*, 255 S.W. 121 (Ky. 1923), the Court addressed the proper location for determining the sales price of gas when the lease did not specify whether the gas should be valued at the wellhead or at the point of sale. In *Rains* the lessee sold the gas in the field for 6 cents per thousand cubic feet, and it paid the lessor a royalty based on that amount. The gas was then transported to the City of Williamsburg where it was sold for 42 cents per thousand cubic feet. The lessor argued that the City of Williamsburg was the actual market, and that sale should be used for calculating his royalty.

The Court rejected the lessor's argument, and in so doing it expressly rejected the expansive "covenant to market gas" advanced by the Appellants. The Court said:

> While the lessee of a gas well may be under the duty of using reasonable effort to market the gas, we are not inclined to the view that this duty, in the absence of a contract to that effect, is so exacting as to require him to market the gas by obtaining a franchise from some town or city and distributing the gas to the inhabitants thereof. On the contrary, he fully complies with his duty if he sells the gas at a reasonable price at the well side to another who is willing to undergo the risk of expending a large amount of money for the purpose of distributing the gas to the ultimate consumers.

Id at 122.

Thus, although there is an implied covenant to market gas, it does not require a producer to incur costs to market the gas at a place other than the wellhead. A lessee need only sell at a "reasonable price at the well side" and pay a royalty on that price. Should the gas be sold at a higher price away from the well, it logically follows under *Rains* that the lessor should bear his respective portion of the costs incurred to obtain that higher price.

The Appellants attempt to distinguish *Rains* and similar cases on the grounds that they involved a sale of gas in the vicinity of the well [Brief at 15-17], while the Appellee made no such sales in this case. But regardless of whether gas is sold at the well, *Rains* makes clear that the lessee's duty to market the gas does not impose on the lessee an obligation to solely bear the costs of moving the gas to the ultimate point of sale.

Rains also stands for the proposition that if a lease does not specify the point at which the landowner's royalty is to be calculated, Kentucky law will presume it to be at the well. The fact that Kentucky follows this presumption is a clear indication that the "marketable product" rule advocated by the Appellants is not harmonious with Kentucky law. It would be inconsistent to apply the marketable product rule, which requires payment of royalties at the point downstream of the well where the gas becomes marketable, and at the same time presume that if a lease is silent as to the point of valuation, the parties must calculate royalties "at the well" where the gas is not marketable.

If Kentucky courts were to accept Appellants' position, Kentucky law would create contradictory royalty valuation points. If a lease specified that the lessor is entitled to a percentage of "the market value of gas ***at the well***" the royalty would actually be calculated a point ***away from the well*** under the Appellants' theory. At the same time, if a lease did not specify the point of valuation, the royalty would be calculated ***at the well***. The Appellants' position is simply untenable.

Kentucky's highest court reiterated its approval of valuing gas at the wellhead in *Warfield Natural Gas Co. v. Allen*, 88 S.W.2d 989 (Ky. 1935). The lease in *Warfield* called for a royalty of "one-eighth of proceeds received" from the sale of gas from the property, but it was silent as where the gas should be valued to determine those "proceeds." *Id.* at 990.

Rather than sell the gas at the well, the lessee transported the gas to another location where it could obtain a more favorable price. The lessor claimed he was entitled to receive one-eighth of the "proceeds" of that distant sale. The lessee contended it only had to pay one-eighth of the price it would have received if it had sold the gas in the field. *Id.*

The *Warfield* Court first followed *Rains* and found that, absent a lease provision specifying the market place for the gas, the market would be the place of production (*i.e.*

the well). *Id.* at 991. Based on that determination, the *Warfield* Court concluded that the lessee was only required to pay the lessor one-eighth of what it would have received had it sold the gas at the well, saying:

> **Nothing was said in the lease about a sale elsewhere and this lease must be held to mean one-eighth of the gross proceeds of a sale of the gas at the well side, and that is all for which the defendant must account even though it may market the gas elsewhere and get a much greater sum for it.**

Id. at 992 (emphasis added). Thus, the lessor was only entitled to one-eighth of the proceeds it would have received had the lessee sold the gas at the well. The lessor neither bore any of the post-production costs, nor did it receive any of the benefits of the higher sales price achieved by those costs.

Since today there is generally no field price for gas, to comply with the *Warfield* Court's decision, a producer would have to deduct the post-production costs from the distant sales price to arrive at a wellhead price. That is exactly what the Appellee did. Such a procedure is all the more appropriate when the lease expressly requires the payment of "market value **at the wellhead,**" thereby establishing the place of valuation.

More than twenty years after *Warfield*, the Court reaffirmed its position in *Reed v. Hackworth*, 287 S.W.2d 912 (Ky. 1956). In *Reed*, the lessee sold the gas at a distant market for a far higher price than would have been available at the well. *Id.* at 912, 914. As in *Warfield*, the lease was silent as to the place of valuation, and in accordance with the *Warfield* opinion, the Court found the price should be determined at the well. *Id.* at 912.

Like the Appellants, the lessor in *Reed* claimed it was entitled to one-eighth of the proceeds from the sale at the higher price. The Court disagreed based on *Warfield* and similar authorities saying, "the lessee need account only for the recited proportion of a sale at the well side, even though he may market the gas elsewhere for a greater sum." *Id.* at 913. The Court determined that the lessor was only entitled to one-eighth of the value of the gas based on the prevailing price at the well. *See Id.* at 914.

Under well-established Kentucky common law, unless the lease specifically states otherwise, the value of gas is determined at the well. If the lessee obtains a higher price elsewhere through additional expenditures, that does not change the amount owed to lessor. Based on this authority if the lessee gives the lessor the benefit of the higher sales price at a distant market, the lessee should be entitled, as a matter of law, to deduct the post-production costs incurred to obtain that higher price in calculating the lessor's royalty.

II. NO SUPPORT EXISTS IN KENTUCKY LAW FOR THE "MARKETABLE PRODUCT" RULE ADVANCED BY APPELLANTS.

Kentucky has never followed the marketable product rule, and the Appellants cite no Kentucky case which applies that rule. The Appellants rely only on the following *dicta* in *Warfield*:

> Defendant had the exclusive right to produce the gas and to market the gas. It was as much its duty to find the market as to find the gas. Nothing is said about its expenses in doing either. It must be presumed that the payment by the defendant of its expenses in doing both is the consideration it is to pay for its seven-eighths of the proceeds, for it pays no other and it certainly gets the lion's share.

Warfield, 88 S.W.2d at 991. While this passage may be read to suggest that the producer should bear the post-production costs, the holding in *Warfield* completely refutes the Appellants' argument.

In *Warfield*, the Court held that the royalty should be based on the proceeds of the gas as measured at the well. Consequently, while the landowner in *Warfield* bore no post-production costs, neither did it benefit from the higher sales price obtained at the distant market. Nothing in *Warfield* suggests that a lessor could have the benefit of the higher sales price without bearing its share of the post-production costs.

The construction of any lease begins with the plain language of the document. Kentucky courts recognize that the implied covenant to market gas is applicable only when a lease is silent on the issue. For example, in *American Wholesale Corp. v. F&S Oil & Gas Corp.*, 46 S.W.2d 498 (Ky. 1932), a case involving a failure to market any gas, the court described the implied covenant as an obligation "which the courts, *in the absence of an expressed provision*, regard as part of every oil and gas lease." *Id.* at 501 (emphasis added); *see also*, *Carroll Gas & Oil Co. v. Skaggs*, 21 S.W.2d 445, 447 (Ky. 1929) ("In the absence of such provision, there is an implied duty to market the product . . . ."). Here, the express provisions of the leases call for a royalty "at the well," which necessarily dictates that post-production costs must be deducted from the sales price received away from the well in calculating royalties.

In the analogous context of the implied covenant to develop gas, Kentucky courts have consistently disregarded the implied covenant when the express terms of the lease are inconsistent with it. *See Conley v. Wheeler-Watkins Oil & Gas Co.*, 288 S.W. 350, 352 (Ky. 1929) ("[T]he court cannot imply an obligation which would be inconsistent with the plain language of the contract."); *see also*, *Swiss Oil Corp. v. Riggsby*, 67 S.W.2d 30, 34 (Ky. 1933) (writing of the implied covenant to develop, that "[n]either in purpose nor in effect does such an implied provision abrogate or encroach upon the rule that express provisions of a contract shall control").

To give the implied covenant effect over the express language of the leases in this case would be contrary to Kentucky law, and it would improperly strike the "at the well" language from the leases. Such a decision would call into question millions of other oil and gas leases with similar language. No implied covenant can be read to override the plain language of a lease, and KOGA urges this Court not to upset settled well-settled Kentucky law and countless industry leases on this point.

III. THE MARKETABLE PRODUCT RULE IS A MINORITY RULE WITH MANY FLAWS THAT DISCOURAGE GAS PRODUCTION.

The "Marketable Product Rule" has not only been rejected by a majority of courts,[2] but is has been severely criticized by scholars as well. In an article entitled *The First Marketable Product Doctrine: Just What is the Product?* the authors discuss at least nine significant flaws in that rule that make it untenable. Byron C. Keeling and Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What is the Product?*, 37 St. Mary' s L.J. 1 (2005). Among those criticisms is that, although the doctrine purports to arise from a contract law analysis, it actually fails to apply the rules of contract construction. For instance, contract laws may not be altered by a court, nor may it be construed against its drafter unless it is ambiguous. The leases at issue unambiguously indicate that the price should be "at the well," and those terms' plain meaning, as set forth above, includes payment of royalties after deduction of post-production expenses. Imposing the marketable product rule to require a contrary result violates those rules of construction.

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[2] *See, e.g., Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 240 (5th Cir. 1984) (construing Mississippi law); *Martin v. Glass*, 571 F. Supp. 1406, 1415-16 (N.D. Tex. 1983); *Emery Res. Holdings, LLC v. Coastal Plains Energy, Inc.*, 915 F. Supp. 2d 1231, 1240 (D. Utah 2012); *Atl. Richfield Co. v. Cal.*, 214 Cal. App. 3d 533, 541-42 (Cal. App. 1989); *Merritt v. Sw. Elec. Power Co.*, 499 So. 2d 210, 213 (La. App. 1986); *ConcocoPhillips Co. v. Lyons*, 299 P.3d 844, 851 (N.M. 2009); *Bice v. Petro-Hunt, LLC*, 768 N.W.2d 496, 502 (N.D. 2009); *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147, 1157-58 (Penn. 2010); *Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133, 135 (Tex. 1996).

The doctrine does not give effect to the plain terms of a royalty clause. *Id.* at 85. If the lease says the royalty is to be calculated "at the well," only a royalty calculated using the "net back" method implements that contract language.

The doctrine does not correctly apply the implied covenant to market. The implied covenant to market is not a valid analytical foundation for the doctrine because the covenant to market requires only that a lessee make reasonable efforts to obtain the best price possible, it does not state anything about a lessee being required to employ a particular mechanism to calculate a royalty. *Id.* at 92. In addition, the doctrine is not fair to lessors who receive their royalties in kind and it may give some lessors a windfall because they get the benefit of a higher sales price without sharing in the cost to achieve that higher price.

Finally, the marketable product yields inconsistent and illogical results like payment of the same royalties for gas of different qualities. For instance, if the treatment costs are not taken into account when calculating royalties, then a lessee would have to pay the same, increased royalty treatment for poor quality gas that requires treatment as it pays for high quality gas that requires no treatment. This makes the "marketable product" rule a poor policy choice, as it encourages production of only higher quality gas fields, and it discourages production of lower quality gas fields. This result certainly runs contrary to the public policy to "encourage the maximum recovery of oil and gas from all deposits thereof......" KRS 353.500(1).

The marketable product rule is a flawed doctrine, which if adopted, would change Kentucky law, discourage natural gas exploration and production, and significantly impair Kentucky's oil and gas industry. It should be rejected.

CONCLUSION

In Kentucky, "at the well" means "at the well." It does not mean "at a distant sales point." When a lease says "at the well," that is the place where royalties should be calculated. To do so, the post-production costs should be deducted from the actual sales price received at the distant location to determine the "at the well" sales price.

Although a duty to market gas is certainly implied in oil and gas leases under Kentucky law, that implied obligation cannot override the plain language of the parties' agreement fixing royalty prices "at the well." As *amicus curiae*, KOGA urges the Court to not abandon well-settled law construing that term consistent with its plain meaning.

Respectfully Submitted,

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